



# EDISON



## Illumination: Equity strategy and market outlook

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## Global perspectives: Interesting times for CBs

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- **Resilient forecasts for profits growth in 2017 keep the equity bears at bay in the short term.** Although a modest degree of weakness in consensus earnings forecasts has appeared recently, earnings growth for developed markets is still forecast to be close to 10% in 2017.
- **Yet valuations across credit and equity markets highlight the need for caution for the medium term.** Across developed equity markets, risk premia remain in our view compressed by central bank policy and are at levels which are unusually low on a historical basis. This is not a new argument for caution but no less relevant as each of the ECB, US Federal Reserve and Bank of England are finally starting to remove monetary stimulus from the financial system.
- **Is this the Goldilocks level for the euro?** Amidst the gnashing of teeth at the rise in the euro we would highlight that the recent increase is not extraordinary and may in fact be helpful in achieving a convergence of economic performance across the eurozone. In our view, the ECB is likely to try to set policy with an eye to maintaining the euro close to current levels.
- **We continue to believe that portfolios should be cautiously positioned.** This cautious recommendation has been in place since Q1 and, we would argue, has been appropriate as progress in equity markets has been modest even if some markets are still close to all-time highs. This is a different market to early 2016, when the risks were more in evidence and, as a result, we were able to take a much more constructive view on risk assets such as equities and corporate bonds.

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## Interesting times for central banks

### If faster growth is just around the corner, why is the US yield curve flattening?

Despite our cautious stance on risk assets, the low-volatility/high-valuation regime in both equities and credit has continued into the autumn. Exhibit 1 shows that US junk bond yields relative to US government bonds are close to their tightest levels over the last 25 years, while the US market's price/book level is now at a new record. In the eurozone and UK valuations are close to cycle highs. This is not a time when rational strategic investment analysis is likely to conclude with an aggressive portfolio positioning.

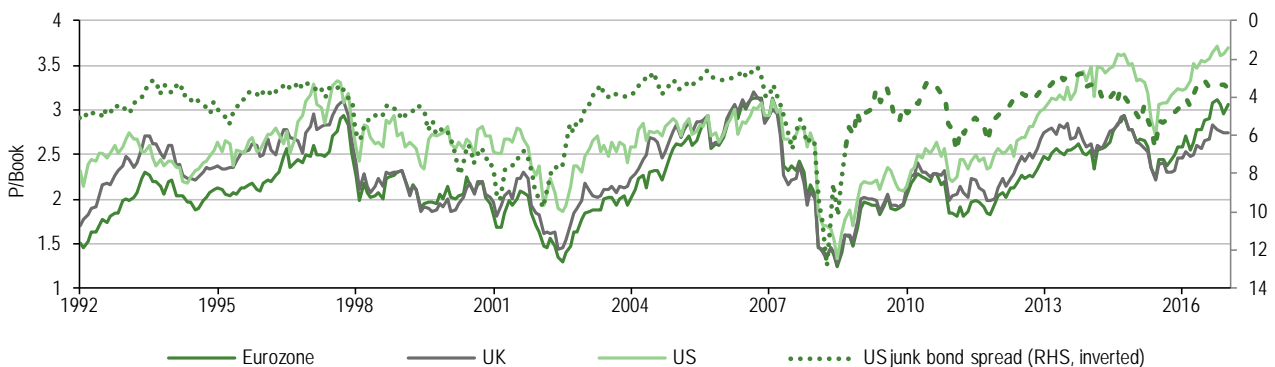
We continue to view these low expected returns primarily as an intended consequence of global central banks' unconventional monetary policies over prior periods. It is not a new argument but no less relevant. Within the same monetary organisations there may be a scholarly debate on the extent to which QE has inflated asset prices, but for ordinary investors the question is far from academic.

The US Fed only yesterday confirmed the details of the timing and quantity of the reduction in its balance sheet. Furthermore, October brings details of the ECB's plans to reduce the net purchases of its own QE programme. We understand from press reports that the ECB is currently split in terms of its future policy in respect of the duration of QE, but the direction of travel is clearly a reduction in monetary accommodation.

Central banks often appear quick to claim credit for the improvement in economic conditions following the financial crisis of 2008. In turn, investors seem to have become conditioned to expect asset price support whenever there is potential for a downturn. However, it remains an unusual era in the history of developed markets. In some respects, it could be argued to be an era of central bank economic planning.

Nevertheless, the decline in long-term bond yields over the summer questions the sustainability of the economic expansion as yield curves flatten. It also remains to be seen whether investors will reappraise the low level of risk premia in global markets as QE in the US and eurozone is scaled back or withdrawn. The volatility of gilt yields and sterling over the last week demonstrates once more just how reliant market prices have become on so few policymakers' words.

**Exhibit 1: Developed market price/book multiples and junk bond spread**



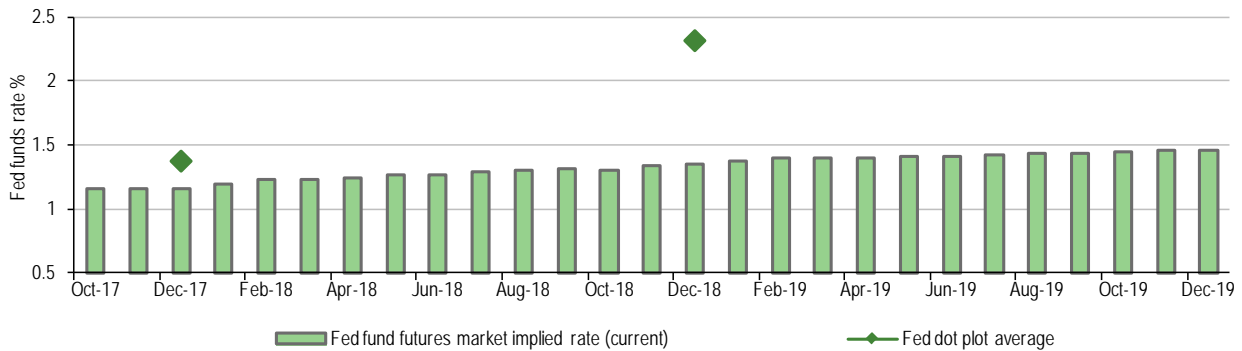
Source: Thomson Reuters Datastream

### Markets call the US Fed's bluff

There is also, and not for the first time, a growing divergence between the Fed's dot plot interest rate projections and futures-implied market expectations, Exhibit 2. Fixed-income investors currently believe that the Fed will be forced to ease the trajectory of interest rate increases – and by

implication believe growth will be weaker than the Fed is currently forecasting. US 10-year rates fell to as low as 2.1% from 2.4% earlier in the summer, although in recent days have risen back to 2.2% as fears over North Korea have ebbed. We did expect the Fed to change tack at September's FOMC meeting and lower its interest rate projections for 2018, if only to ensure investors did not start to anticipate an inversion of the US yield curve, given its association with impending recession.

**Exhibit 2: Increasing divergence between Fed dot plots and market-implied expectations**



Source: Thomson Reuters Datastream

To our surprise, however, the Fed not only reconfirmed the probability of a rate increase later in the year but, in addition, continues to forecast three further rate increases in 2018. There was no change to its median projection of 2.1% US rates by the end of 2018. At the same time, the Fed announced the pace of reduction in its balance sheet which, while an initially modest US\$10bn per month in October, will rise to US\$50bn per month by the end of 2018. At the press conference Yellen was also clear that the balance sheet reduction would continue unless there was a material change in the economic outlook and that interest rates remained the primary policy tool.

The initial market reaction has been for the yield curve to flatten further as investors price in an increased probability of a Q4 rate increase while US 10-year bond yields rose by only 3bp. Yellen acknowledged the gap between market-implied expectations and the Fed's projections, but we do not believe that her explanation, based on the difference between the mean and mode and negative term premia, can fully account for such a large gap by the end of 2018. How this divergence is resolved will be critical for markets in the coming quarters.

Even if in part due to Trump's failure to progress his administration's US tax reform and stimulus spending agendas, a falling dollar, falling US rate forecasts and declining bond yields are all consistent with a slowing growth outlook for 2018. Furthermore, as we explored in our August strategy note, by facilitating the build-up of further indebtedness in the corporate and household sector, US central bankers could even be said to be in a liquidity trap of their own making. Over a number of cycles since the 1980s the Fed has been unable to buck the trend of ever declining interest rates.

However, one positive aspect in the short term for markets that should not be ignored is the possibility of the Fed being re-staffed by Trump appointees during Q118. Both the chair and vice chair positions are open, in addition to two Fed governor positions. The temptation for Trump to appoint dovish individuals in respect of both monetary policy and financial deregulation may be difficult to resist.

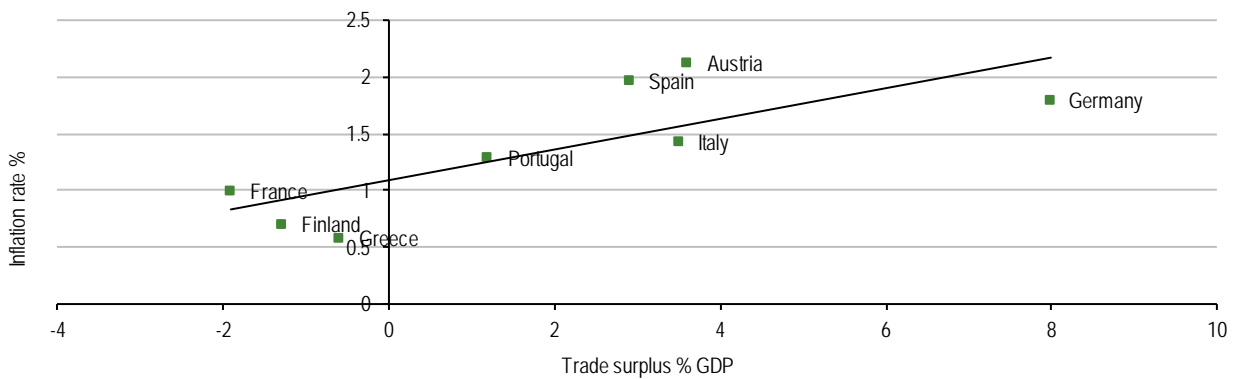
However, for the longer term, there is a clear consensus that the speculative excesses caused by lax financial sector regulation prior to 2008 ultimately proved highly damaging, both for risk assets and the economy. Balancing the short- and long-term considerations will therefore be a challenge for investors should there be staff turnover at the Fed. Even now, there is little clarity on which individual will become Fed chair – the recent favourite, former Goldman COO Gary Cohn, now appears out of the running.

### Draghi's dream: A Goldilocks level for the euro?

According to recent press reports, there appears to be at present a split at the ECB in terms of how to wind down the pace of the ECB's bond purchases, due to fears of increased strength in the euro. However, in our view, the positive response of the euro to signs of improving economic momentum in the eurozone is likely to be highly beneficial to the goal of synchronising the eurozone economy.

Conveniently, it is the exporting nations of the eurozone that have the greatest inflation rates and faster growing economies, Exhibit 3, at present. A stronger euro acts as a natural tap on the brakes on corporate activity in these regions and also puts downward pressure on inflation rates. In this way, a strong euro means the more domestically focused regions in the periphery of Europe can continue to benefit from very loose domestic monetary policy, and move further away from the crisis era of 2011-12. It is notable that France and Germany are at opposite ends of Exhibit 3. Had the euro failed to strengthen, we would have little doubt that the Bundesbank would have remained a vocal critic of the ECB's continuation of ultra-loose monetary policy as the economy rebounded.

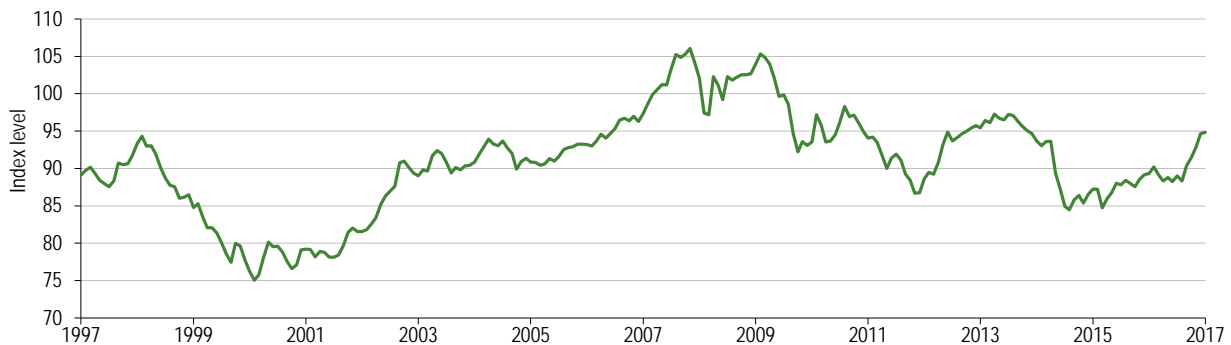
**Exhibit 3: Inflation and trade balance as a percentage of GDP**



Source: Thomson Reuters Datastream, OECD

The question now, therefore, is what level of the euro policymakers are comfortable with. The recovery of the euro is not all down to the eurozone's economic recovery; eurozone growth has picked up just as Trump's tax reform and stimulus agenda became stuck in the US political system. Pincerred between these two factors, the euro has quickly squeezed higher, Exhibit 4.

**Exhibit 4: Euro trade-weighted index**



Source: Thomson Reuters Datastream

We know from Draghi's most recent comments that ECB forecasts are modelled on a €/US\$ FX rate of 1.18, close to current levels. Draghi had a clear opportunity at the most recent ECB press conference to warn investors that the ECB was uncomfortable with the rate of appreciation of the euro, but chose not to take the opportunity. Instead, there was only a relatively mild reference to FX volatility. Draghi studiously avoided setting any line in the sand for the level of the euro, which rose further above 1.20 as he spoke.

It may seem like ancient history, but the euro in fact has not even fully recovered from the drop of 2013, ahead of the ECB's decision to pursue QE. The strength of the euro will squeeze export-led nations such as Germany harder than the periphery of the eurozone, a potentially desirable outcome. Furthermore, inflation forecasts are still below target and most recently were revised lower due to the strength of the currency.

Due to the higher exchange rate, a slower taper of QE and/or longer period of very low interest rates may be achievable, providing further time for the slower growing members of the eurozone to catch up ahead of any tightening of policy. In such a Goldilocks scenario, we therefore believe that the ECB will aim to avoid a significant move in the euro in either direction.

## **Conclusion**

We continue to believe that long-term investors should prioritise valuation metrics over the prospects for a single year's positive profits growth during 2017. Risk premia are unusually low in equity and credit markets on a historical basis and we do not feel there is a wall of worry to be climbed in terms of upcoming monetary policy decisions in 2018, which might otherwise be expected to push markets higher in the final quarter. By contrast, due to this extraordinarily gradual monetary tightening cycle globally, investors appear too relaxed in our view.

There appears to be some concern in policymaking circles in respect of the strength of the euro and its impact on ECB policy. We believe the recent strength allows the ECB to maintain a gradual trajectory in terms of the removal of monetary accommodation and therefore assists the policy objective of achieving greater convergence of economic performance across the eurozone. In our view, the current level represents a Goldilocks position, which future ECB policy will aim to maintain.

There is no change to our cautious outlook on equity markets and we would also be highly selective in respect of credit exposure at current levels.

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